Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of:	)	
	)	
Petition of BellSouth Corporation,	)	WC Docket No. 05-352
AT&T Inc. and Qwest Corporation	)	
Requesting Modification of RAO Letter 12	)	

Comments of Verizon[1] In Support of Petition

Verizon supports the Petitioners' request to bring the RAO 12 definition of "materiality" used for purposes of the Joint Cost audit[2] in line with the materiality standard used in generally accepted accounting procedures ("GAAP"), by eliminating the *per se* requirement that "the discovery of any error or omission in excess of $ 1 million will result in a correction of the reported results."[3] The Commission has long stated its desire to have regulatory accounting rules that track GAAP reporting, unless there is some regulatory need to have different rules.[4] As Petitioners have demonstrated, no such need exists here. *See* Petition, at 10-11.

---

1 The Verizon telephone companies ("Verizon") are listed in Attachment A.

2 RAO 12 was adopted to address the Part 64 cost allocation rules related to the separation of regulated and nonregulated costs. It directs that "auditors reports should accompany the Report of Annual Revenue Requirement and Joint Cost data, identified as Appendix C of the ARMIS Order . . .; and attest to the accuracy of cost allocations reported therein, including the effects of transactions with affiliates." *See RAO Letter 12*, 3 FCC Rcd 2454, at 1 (1988); *as revised*, 3 FCC Rcd 4401 (1988); *further revised*, 5 FCC Rcd 6783 (1990) ("2d Revised RAO Letter 12"); Errata, DA 90-1507 (rel. Oct. 26, 1990).

3 2d Revised RAO Letter 12 at 6783.

4 *See Revision of the Uniform System of Accounts for Telephone Companies to Accommodate Generally Accepted Accounting Principles (Parts 31, 33, 42, and 43 of the FCC's Rules)*, Report and Order, 102 FCC 2d 964, ¶ 1 (1985) ("GAAP Order") (describing the notice of proposed rulemaking as proposing ways in which the Commission could revise its accounting rules "to accommodate generally accepted accounting principles (GAAP) to the extent practicable"); *id.*, at ¶ 70 ("We are adopting GAAP into the revised USOA for accounting purposes to the extent regulatory considerations permit.").

The $1 million *per se* materiality standard is a relic of rate-of-return regulation, imposed on the local exchange carriers in an era prior to significant local entry, and before their rates were subject to price caps. *Id.* The regulatory landscape is very different today than it was when the $1 million threshold was adopted. As the Commission recognized in the recent *Broadband Title I Order*, the Part 64 cost allocation rules that RAO 12 addresses were designed "to make sure that all of the costs of nonregulated activities are removed from the rate base and allowable expenses for interstate regulated services."[5] The requirements of Part 64 rules are "quite detailed," because they "paralleled the level of detail in the cost-of-service calculations that LECs performed to develop their rates for interstate access services." *Id.* However, all of the larger ILECs now operate under price cap regulation at the federal level.[6] "[B]ecause price cap regulation severs the direct link between regulated costs and prices, a carrier is not able automatically to recoup misallocated nonregulated costs by raising basic service rates, thus reducing the incentive for BOCs to shift nonregulated costs to regulated services."[7] Because minor cost allocation shifts will not impact price cap carriers' rates, there is no need for the

---

5 *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities*, Report and Order and Notice of Proposed Rulemaking, 20 FCC Rcd 14853, ¶ 132 (2005) ("Broadband Title I Order")

6 *See Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order, 5 FCC Rcd 6786, ¶¶ 259-261 (1990)

7 *Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier I Local Exchange Company Safeguards*, Report and Order, 6 FCC Rcd 7571, ¶ 55 (1991), vacated in part and remanded, *California v. FCC*, 39 F.3d 919 (9th Cir. 1994). *See also Broadband Title I Order*, ¶ 133 (Since the Part 64 rules originally were adopted, "[the Commission's] ratemaking methods and those of . . . state counterparts have evolved considerably. This evolution has greatly reduced incumbent LECs' incentives to overstate the costs of their tariffed telecommunications services."); *United States v. Western Elec. Co.*, 993 F.2d 1572, 1580 (D.C. Cir. 1993) (price cap regulation"reduces any BOC's ability to shift costs from unregulated to regulated activities, because the increase in costs for the regulated activity does not automatically cause an increase in the legal rate ceiling.").

Commission to maintain outdated and overly stringent definitions of what level of misallocation will be deemed "material."

In today's market, competition from wireless carriers, cable companies, VoIP providers, CLECs and other new entrants constrains the rates that incumbent local exchange carriers can charge for their services. Intramodal competition from CLECs has increased dramatically even in the last few years,[8] and newer providers, such as wireless and VoIP, are rapidly gaining market share.[9] As the Commission has long recognized, robust competition such as that typifying all segments of today's communications industry assures that rates will be just, reasonable, and nondiscriminatory. *See, e.g., Implementation of Sections 3(n) and 332 of the Communications Act*, Second Report and Order, 9 FCC Rcd 1411, ¶ 174 (1994) ("[c]ompetition, along with the impending advent of additional competitors, leads to reasonable rates."), *id.* ¶ 173 ("in a competitive market, market forces are generally sufficient to ensure the lawfulness of rate levels, rate structures, and terms and conditions of service ..."); *see also Policy and Rules Concerning the Interstate, Interexchange Marketplace*, Second Report and Order, 11 FCC Rcd 20730, ¶ 42 (1996); *Policy and Rules Concerning Rates for Competitive Common Carrier*

---

8 *See* FCC, Wireline Competition Bureau, Industry Analysis and Technology Division, *Local Telephone Competition: Status as of December 31, 2004*, at 1 & Table 1 (2005) (CLECs increased from less than 12 million lines and 4.3 percent market share in 2000 to nearly 33 million lines, and 18.5 percent market share, by December 2004).

9 At least 14 percent of U.S. customers now use their wireless phones as their primary phone, and analysts predict that number to increase to between 29 and 37 percent by 2009. *See* C. Wheelock, In-Stat/MDR, *Cutting the Cord: Consumer Profiles and Carrier Strategies for Wireless Substitution*, at 1 (Feb. 2004); Dinesh C. Sharma, *Consumers Ready to Ditch Landlines*, CNET News.com, Oct. 25, 2005, http://news.com.com/Consumers+ready+to+ditch+landlines/2100-1039_3-5913185.html. VoIP use is expected to rise exponentially over the next few years. *See, e.g.*, Marguerite Reardon, *VoIP Providers Band Together*, CNET News.com, Nov. 2, 2005, http://news.com.com/VoIP+providers+band+together/2100-7352_3-5929200.html ("About 3 million people use voice over IP today . . . [b]ut that number is expected to increase to 27 million by the end of 2009.").

Services and Facilities, First Report and Order, 85 F.C.C.2d 1, ¶ 88 (1980) ("firms lacking market power simply cannot rationally price their services in ways which, or impose terms and conditions which, would contravene Sections 201(b) and 202(a) of the Act").

Moreover, the establishment of any *per se* dollar test for "materiality" is inconsistent with the Commission's prior rejection of such a threshold in the uniform system of accounts. In the *GAAP Order*, the Commission specifically rejected the proposal to define materiality based on a particular dollar limit or percentage of revenues, based on a concern that, "[t]hresholds do not lend themselves to the differing sizes of the companies that will be subject to Part 32." GAAP Order, ¶ 79. If a threshold does not make sense as a basis for making an initial determination of materiality, the same conclusion holds true for determining whether an error uncovered in an audit is material enough to require adjustment. Although the Commission initially declined to adopt the same materiality standard as GAAP, that was again at a time when carriers were operating primarily under federal rate-of-return regulations, where minor costs were more likely to have a potential impact on rates.[10] As explained above, the same situation does not exist under the federal price cap rules. The definition of materiality set forth by the Financial Accounting Standards Board ("FASB"), which is used to determine whether financial records or statements should be corrected to reflect prior errors or omissions, also should be sufficient for RAO 12: "The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment

---

10 *See* GAAP Order, ¶¶ 75-80.

of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."[11]

In addition, even if the Commission believed that some threshold were necessary, the $ 1 million *per se* materiality test set by RAO 12 is far too low. For Verizon, the $1 million represented only .003% of its regulated operating revenues for 2004, and 0.003% of its regulated operating expenses. Verizon calculates that in all jurisdictions, its aggregate nonregulated expense errors would have to be more than sixty times the threshold amount, or nonregulated investment errors would have to be more than one thousand times greater than the RAO 12 standard, to even move interstate return 10 basis points (e.g., from 11.25 to 11.35).

Perpetuating unnecessary audit standards in this environment undermines competition and disserves consumers by imposing unnecessary burdens on ILECs that are not shared by their competitors. It takes hundreds of man hours for Verizon to adjust reports before they are filed, or to refile reports from prior years if the audit findings come afterwards. While this effort is justified if it would correct errors that had a significant impact on Verizon's rates or financial statements, all too often the work is undertaken simply because it was triggered by the RAO 12 threshold.

11 *See* Financial Accounting Standards Board, *Statement of Financial Accounting Concepts No. 2 Qualitative Characteristics* at 10 (May 1980), at http://www.fasb.org/pdf/con2.pdf.

CONCLUSION

The Commission should grant the Petition, and eliminate RAO 12's $ 1million *per se* materiality standard.

Respectfully submitted,

By: ________________________

Michael E. Glover
Of Counsel

Edward Shakin
Ann Rakestraw
VERIZON
1515 N. Court House Road
Suite 500
Arlington, VA 22201-2909
703.351.3174

February 1, 2006

Counsel for the Verizon
telephone companies

THE VERIZON TELEPHONE COMPANIES

The Verizon telephone companies participating in this filing are the local exchange carriers affiliated with Verizon Communications Inc. These are:

Contel of the South, Inc. d/b/a Verizon Mid-States
GTE Southwest Incorporated d/b/a Verizon Southwest
Verizon California Inc.
Verizon Delaware Inc.
Verizon Florida Inc.
Verizon Maryland Inc.
Verizon New England Inc.
Verizon New Jersey Inc.
Verizon New York Inc.
Verizon North Inc.
Verizon Northwest Inc.
Verizon Pennsylvania Inc.
Verizon South Inc.
Verizon Virginia Inc.
Verizon Washington, DC Inc.
Verizon West Coast Inc.
Verizon West Virginia Inc.